COMMONWEALTH OF MASSACHUSETTS
Management Letter
Year Ended June 30, 2004

Commonwealth of Massachusetts
Management Letter
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INDEPENDENT AUDITORS' REPORT

Martin Benison, Comptroller
The Commonwealth of Massachusetts

In planning and performing the Single Audit of the Commonwealth of Massachusetts (the "Commonwealth") for the year ended June 30, 2004, on which we have issued our report dated December 31, 2004, we considered its internal control in order to determine our auditing procedures for the purpose of expressing an opinion on the financial statements and not to provide assurance on the Commonwealth's internal control. However, we noted certain matters involving the Commonwealth's internal control structure and compliance of management of the Commonwealth with laws and regulations that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the Commonwealth's internal control that, in our judgment, could adversely affect the Commonwealth's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Such matters have been reported to the management of the Commonwealth in the "Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based upon the Audit of the Financial Statements Performed in Accordance with *Government Auditing Standards"* dated October 31, 2004 and "Report on Compliance with Requirements Applicable to Each Major Program and Internal Control over Compliance in Accordance with OMB Circular A-133 and on the Schedule of Expenditures of Federal Awards" dated December 23, 2004.

Our consideration of the Commonwealth's internal control would not necessarily disclose all matters in the Commonwealth's internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are considered to be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by the error or fraud in amounts that would be material in relation to the financial statements or in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. However, based on our procedures and the report of other auditors, of the reportable conditions described in the above reports , we consider Finding Number 51 in the "Report on Compliance with Requirements Applicable to Each Major Program and Internal Control over Compliance in Accordance with OMB Circular A-133 and on the Schedule of Expenditures of Federal Awards" to be a material weakness relating to the controls over the Byrne Formula Grant Program administered by the Executive Office of Public Safety.

We also submit our comments concerning certain observations and recommendations relating to other accounting, administrative, and operating matters. These recommendations resulted from our observations made in connection with our audit of the Commonwealth for the year ended June 30, 2004. Our comments arranged by Department, are presented on the following pages.

This report is intended solely for the information and use of management and federal awarding agencies and is not intended to be and should not be used by anyone other than these specified parties.

Yours truly,

December 23, 2004

STATEWIDE OBSERVATIONS

Higher Education Shared Services Center

The Commonwealth should evaluate whether a higher education shared services center would improve the efficiency and accountability of the accounting and student financial aid operations of the community and small state colleges. A secondary goal of a shared services center would be to reduce the operating costs of non-academic functions. Problems encountered in recent years at some of the Commonwealth's colleges combined with the significant turnover experienced by many of these institutions as a result of early retirement incentives offered by the Commonwealth in recent years indicate the need to challenge the current approach to providing the "back room" operations of the state's higher education system.

The use of a shared services center is one approach to improving and providing some uniformity to the accounting and student financial aid operations of many of the smaller institutions of higher education. A shared services center, whether run by a governmental entity or outsourced to a private entity, could provide the following benefits:

1. The ability to keep pace with ever-changing technology
2. Flexibility and scalability
3. The foundation for Internet based e-Business/e-Government
4. The ability to enhance responsiveness and customer satisfaction
5. Best business processes and practices
6. The ability to attract and retain good people
7. Optimizing the allocation of existing resources
8. Cost savings and cost control
9. Better information for management decision making
10. Continuous improvement with new ideas and service offerings

Various governmental entities have begun to use shared services centers or similar concepts. In addition, the Apollo Group (University of Phoenix) has used outsourced providers to service both its accounting and student financial assistance functions.

In considering whether to move to a shared services concept the Commonwealth should perform the following steps:

- Complete a business process diagnostic evaluation at a number of institutions;
- Prepare a requirements definition of core financial functions;
- Obtain buy-in from upper management and user institutions;
- Develop documentation deliverables;
- Perform a best practices review of current operations and new technology; and
- Research the cost of communications links to the shared services center.

EOHHS Reorganization

With a goal of improving the effectiveness, efficiency and economy of human service operations, the Commonwealth undertook the reorganization of the Executive Office of Health and Human

Services ("EOHHS") in 2004. EOHHS, in conjunction with the Executive Office for Administration and Finance, is responsible for implementing the reorganization.

EOHHS and the 17 departments or divisions under its umbrella are the largest Executive Branch Secretariat in the Commonwealth. It is estimated that EOHHS administers more than 100 federal programs totaling approximately $7B as well as administering an equal amount of state funds. One of the primary objectives of the reorganization that is still in process is the consolidation of some of the administrative functions in these departments. As occurs with all reorganizations and consolidations, some individuals are required to assume new roles and perform new functions. During the course of the FY 2004 audit some accounting issues arose because documentation provided to the individuals who assumed new roles and/or performed new functions was not adequate and those individuals lacked sufficient experience to understand the deficiencies in the information that was being provided. Additionally, in some cases, access to the individuals who used to perform those roles or functions, was limited. While all of the issues were satisfactorily resolved, the time and effort involved to achieve the resolution was extensive.

The effective coordination of the accounting and financial reporting functions with the programmatic function is crucial to the overall operation of all programs administered by EOHHS, particularly now that many of the administrative functions are being physically separated from the programmatic functions. This is most especially the case for federal programs because many of these programs require the Commonwealth to match federal funds or have a cap on administrative spending. It is recommended that EOHHS take all steps necessary to ensure that the policies, procedures and processes to be followed by individuals in their new roles are adequately documented so that institutional memory and knowledge is memorialized. Such documentation would improve the overall internal control environment within these departments and help ensure compliance with federal and state laws and regulations.

Reporting on the Commonwealth's Retirement Systems

The Commonwealth is unique among state governments in that it does not have separately prepared and audited public employee retirement system financial statements. The investments of the Commonwealth's three public employee retirement systems are audited by an independent auditor as part of a single financial statement. This audit, however, does not cover any aspect of the retirement systems except for the investments and related investment activity. Accordingly, there is no comprehensive financial statement for the individual plans except as that information may be pieced together in the Commonwealth's financial statements. Even then, the presentation combines all three retirement systems which further limits the ability to assess each plan on an individual basis.

The Commonwealth should consider preparing separate stand alone financial statements for each of the retirement systems that include all of the assets, liabilities, revenues and expenses of each system.

Employee Recognition Programs

As the Commonwealth recovers from the uncertain economic period of 2003/2004 it is important to look at programs that produce cost savings while at the same time rewarding and retaining the resources needed to run the business of government. The impact of the loss of talented, experienced employees has been evidenced throughout the Commonwealth in the wake of the

ERIP program. At this time, it is more important than ever to ensure that the retention of talented employees is a high priority.

The Pride in Performance in Massachusetts program has cut back on the emphasis of employee recognition for excellent performance in recent years. At one time, excellence was rewarded with public recognition at a formal dinner. Currently, such performance is rewarded with a brief reception, the attendance at which is strictly limited.

Rewarding and retaining talented employees has always been a challenge for governmental entities. It is always more of a challenge to reward employees in tight economic times which, unfortunately, generally correlate to the periods when these individuals are also being asked to do more with less. In looking at models from other states, several programs are worth noting.

One idea is a "Shared Savings Program" modeled after similar private sector models. This program encourages employees to submit ideas for managing, building or buying something more efficiently. Any actual savings go into a special account and, after a year, half of the savings recognized in the department goes to the department employees.

A second idea is a quality service award, which allows individual employees to earn financial recognition for accomplishments. The program awards up to $10,000 to one person or to a number of people. Massachusetts does have the Carballo award which awards up to $1,000 to one person or group.

While other types of programs exist, the goal for Massachusetts should be to reward talented employees while reducing overall costs and improving operational efficiency.

Workers' Compensation and Group Health Insurance

The Commonwealth should establish a funding schedule to accumulate assets to satisfy the current under-funded liability related to the internal service funds. As of June 30, 2004, the unfunded liability for the workers compensation and group health insurance funds was $304M and $37.4M, respectively. Under the new reporting model, these balances represent accumulated liabilities and, as such, are reported as liabilities in the governmental fund statements directly reducing the "net assets" of the Commonwealth. Ultimately, these obligations exacerbate the Commonwealth's negative unrestricted net asset position.

Available options to furnish the necessary funding include a surcharge to the current statutory chargeback to state agencies, an annual appropriation based upon an actuarially calculated funding schedule, a redirection of investment earnings, and other actions. The Office of the Comptroller and the Legislature should coordinate their efforts to evaluate all options and select the most appropriate steps to satisfy the existing liabilities and fund future liabilities as incurred.

Whistle Blower Hotline

In recent years there has been increased scrutiny on organizations to detect fraud in the workplace. One way, increasingly used by governments and private companies, to identify fraud is a confidential whistle blower hotline where both employees and citizens can call and report any potential fraud or abuse.

The Commonwealth has several such hotlines. We were able to identify one at the Executive Office of Health and Human Services for the reporting of fraud in any public assistance program. Another is at the Office of the Inspector General, to report suspected fraud, waste and/or abuse anywhere in state government. In our attempt to identify the number and type of hotlines that exist in the Commonwealth, however, we found it very difficult to find them.

We recommend that the Commonwealth assess the departments at which it would be prudent to establish whistle blower mechanisms. In those cases where it does make sense, access should be readily accessible to any employee of the Commonwealth and/or the taxpayers of the Commonwealth. The latter can be accomplished through more prominent or obvious posting on the Commonwealth's homepage and/or on departmental websites and/or through the establishment of a separate, centralized phone number listing within the Commonwealth's main telephone directory.

Education Program

The recently implemented governmental reporting model requires governments to provide basic financial statements both at a fund level, similar to what has historically been reported for governmental entities, and at a government-wide level. The government-wide statements are intended to focus attention on the overall financial condition of the government. The display of the overall operations of the government, including all debt and long-term assets, makes it easier to determine whether the government, as a whole, is better or worse off than the previous year.

This emphasis on government's overall financial condition is similar to the emphasis on the issue of intergenerational equity which focuses on the development of plans to not only pay for long-term obligations, both debt related and non-debt related, but also on the need for the repair or replacement of fixed assets and infrastructure. The intergenerational equity focus is not so much on the growth of net assets as it is on the maintaining of a net asset balance that demonstrates a sound and stable financial condition with sufficient resources to offset economic downturns.

These concepts are all tied to the notion of sustainability. Sustainability is the notion that current economic and consumption patterns should not reduce opportunities for future generations by depleting or impairing resources. Many businesses worldwide have demonstrated that they can operate profitably while employing sustainable practices. Similarly, many governments have adopted and implemented sustainable policies and business practices.

To that end, financial statement models should be developed that demonstrate the implications of the Commonwealth's long-term capital as well as debt related and non-debt related needs and stress the need for plans to support the future financing of obligations and assets together with the implications of legislative action on financial reporting. This will ensure that decisions made at the legislative level will be consistent with best interests of the taxpayers of the Commonwealth.

This is particularly important in the Commonwealth because the Commonwealth has a long history of paying for and financially supporting its authorities as well as local government capital projects. The negative unrestricted net asset balance is, in part, reflective of the fact that the Commonwealth is carrying significant long-term debt obligations for assets that are owned by cities, towns and independent authorities of the Commonwealth. This is a prime example of the type of legislative decisions that are made that have a significant financial statement impact in the new reporting model.

The concepts defined above are commercial in nature and are not concepts on which governments have historically focused. Part of the rationale for the new reporting model was to begin to change those historical perspectives. Given this change in focus, the Office of the Comptroller should consider developing a training program to educate the administration, the Legislature and other potential users of the financial statements about these concepts.

Display of Social Security Numbers

The US Government Accountability Office ("GAO") issued a report in November 2004 explaining that social security numbers ("SSNs") appear in any number of records exposed to public view almost everywhere in the nation, primarily at the state and local levels of government. State agencies in 41 states, including Massachusetts, and the District of Columbia reported visible SSNs in at least one type of record and a few states have them in as many as 10 or more different records. SSNs are most often to be found in state and local court records and in local property ownership records, but they are also scattered throughout a variety of other government records. In general, federal agency display of SSNs in public records is prohibited under the Privacy Act of 1974. While the act does not apply to the federal courts, they have taken action in recent years to prevent public access. With regard to the SSNs maintained in public records, various state and local officials commonly reported needing them for identity verification. A few, however, said they had no use for the SSNs, but that documents submitted to their offices often contained them. States also commonly reported using the SSNs to facilitate the matching of information from one record to another. The federal courts largely collect SSNs when required by law to do so; however, due to privacy concerns, SSNs are not in documents that are available electronically to the public.

Public records with SSNs are stored in a multiplicity of formats, but public access to them is most often limited to the inspection of individual paper copies on site or via mail by request. Few state agencies make records with SSNs available on the Internet; however, 15 to 28 percent of the nation's 3,141 counties do place them on the Internet and this could affect millions of people. Overall, GAO found that the risk of exposure for SSNs in public records at the state and local levels is highly variable and difficult for any one individual to anticipate or prevent.

Another form of SSNs exposure results from a government practice that does not involve public records per se. GAO found that SSNs are displayed on cards issued to millions of individuals under the authority of federal agencies for identity purposes and health benefits. This involves approximately 42 million Medicare cards, 8 million Department of Defense identification cards, as well as some insurance cards, and 7 million Veterans Affairs identification cards, which display the full nine-digit SSNs. While some of these agencies are taking steps to remove the SSNs, there is no government-wide federal policy that prohibits their display.

Although we did not examine this phenomenon across all federal programs, it is clear that the lack of a broad, uniform policy has the potential to allow for unnecessary exposure of personal SSNs. Consistent with the GAO recommendation, we recommend that the Commonwealth identify all those state activities that require or engage in the display of nine-digit SSNs on health insurance, identification, or any other cards issued to state government personnel or program beneficiaries, and devise a statewide policy to ensure a consistent approach to this type of display. The policy should extend not only to the use of identification or other cards where such information may be accessible but should also extend to the manner in which such confidential information is managed and disseminated internally, how access to such information should be controlled when subject to outside inspection (audit or regulatory review) and an assessment of whether such information is protected when systems are accessed externally via VPN or other means.

Service Efforts and Accomplishments Reporting

A key responsibility of state and local governments is to develop and manage programs as effectively and efficiently as possible and to communicate the results of these efforts to the stakeholders. To that end, a major focus in government today is departmental accountability. Service Efforts and Accomplishments Reporting ("SEA"), as summarized in GASB Concepts Statement No. 2, "Service Efforts and Accomplishments Reporting", measures performance through various indicators and attempts to gauge departmental efficiency. Performance measurements when linked to the budget and strategic planning process can assess accomplishments on an organization-wide basis. When used in the long-term planning and goal setting process, meaningful performance measurements assist government officials and taxpayers in identifying financial and program results, evaluating past resource decisions and facilitating qualitative improvements in future decisions.

Because the primary purpose of governmental entities is to maintain or improve the well-being of their citizens, information that will assist users in assessing how efficiently and effectively the Commonwealth is in achieving its primary purpose could play an important role in future financial reporting. The assessment of a governmental entity's performance requires information not only about the acquisition and use of resources, but also about the outputs and outcomes of services provided, and the relationship between the use of resources and their outputs and outcomes. These decisions take on an added level of significance as the Commonwealth continues to be asked to provide greater levels of service during a period of diminishing financial resources.

An expanding number of governmental entities presently are developing and using SEA measures. The Government Accounting Standards Board ("GASB") may ultimately require this reporting as part of the entities basic financial statements. In fact, in August 2003, the GASB issued a document entitled, "Reporting Performance Information: Suggested Criteria for Effective Communication" which provides its perspectives on the reporting of performance information.

We suggest the Commonwealth evaluate the use of SEA reporting as an additional tool to promote accountability and efficiency. As the services provided by the Commonwealth are diverse and often complex in nature, we further recommend that program and budget personnel, elected officials, internal auditors, professional groups, and citizens in addition to financial management become active in developing and using SEA measures.

Investor Relations Programs and Related Disclosures

The Commonwealth should review its investor relations program. An effective investor relations program that responds to the informational needs of investors, bond insurers, liquidity providers, rating analysts, credit enhancers, counter parties and other constituents interested in obtaining financial and operational information on bond issuers can reap many benefits to the

Commonwealth. One of these benefits could be the lowering of the Commonwealth's borrowing costs.

In spite of other events that have occurred in the last few years in the securities markets, the United States Securities and Exchange Commission ("SEC") continues to focus on municipal securities and investor information because of the emerging dominance of individual investors in the municipal market. More than 70% of the outstanding obligations are held by or for individuals either directly or through bond funds and nearly 40% of the total is held by individuals themselves or in their personal trust accounts. Because many investors purchased their bond holdings in the secondary market, the disclosures to that segment of the marketplace are receiving a growing level of attention. The SEC has begun to focus on the information contained on governmental websites and whether the information has the potential to mislead investors. Properly used, the website is an important element of an investor relations program and an aid in complying with the SEC rules.

The Government Finance Officers Association ("GFOA") has issued a recommended practice on "Maintaining an Investor Relations Program". The centerpiece of the GFOA program is a commitment to provide annual financial, operating, and other significant information in a timely manner consistent with federal and state laws and SEC rules. Issuers were encouraged to consider addressing the following concerns:

1. Identify individuals responsible for speaking on behalf of the issuer.
2. Develop procedures for identifying and selecting information, both positive and negative, to be made available to investors.
3. Develop procedures for disseminating information so that it gets to all parts of the market simultaneously.
4. Develop procedures to ensure that potential investors receive a copy of the preliminary official statement at least one week in advance of a bond sale.
5. Identify ways to stay abreast of issues that are likely to be of concern to investors.
6. Develop and maintain a good relationship with rating agencies.
7. Establish procedures to ensure that financial statements or other information needed for disclosure purposes are completed on a consistent schedule from year-to-year and prior to the date established in any contractual commitments.
8. Delineate clearly the roles and disclosure responsibilities in conduit borrowings.
9. Engage in marketing activities to alert investors of a pending bond sale.
10. Identify investors who hold the issuer's bond to improve communications.
11. Be aware that legal issues may exist with respect to securities information provided by electronic means.

Recent industry publications have described examples of investor relations programs and specifically the fact that most investors do not accept the minimal disclosures required by SEC Rule 15c2-12 as sufficient. The following steps, over and above what has been recommended by the GFOA, have been recommended as ways that such programs may be enhanced:

1. Conduct research into the legal requirements.
2. Examine the information needs of the bond rating agencies, bond insurers and underwriters regarding their requirements to comply with SEC and Municipal Securities Rulemaking Board rules.

3. Develop a cover sheet for all filings with the Nationally Recognized Municipal Securities Information Repositories ("NRMSIRs") that contained CUSIP numbers. Such a cover sheet is to accompany all filings and is necessary for the NRMSIRs to be able to tie disclosure documents to specific bond issues.
4. Add an "investor relations site" to the government Web page.
5. Develop a quarterly investor newsletter that is posted on the Web site.

In the current environment, the development of such a program can only enhance its relationships with both the investor community and the SEC. In addition, by providing information directly to the investor community and increasing confidence in the marketplace, the Commonwealth may ultimately increase investor interest in the debt with a corresponding lower interest rate.

Use of Comparative Trend Data for Financial Analysis
The Commonwealth's Comprehensive Annual Financial Report ("CAFR") provides a wealth of data that the Commonwealth and other interested users can use to analyze the Commonwealth's financial position. The Commonwealth enhanced this comparability in FY 2004 by including certain optional aspects of GFOA's CAFR award program, which is part of GASB Statement No.44, "Economic Condition Reporting: the Statistical Section, an Amendment of NCGA Statement 1". This was done in anticipation of implementing GASB Statement No. 44 in FY 2006. Of course, considering financial data in isolation can lead to inappropriate conclusions – appropriate context is essential for sound interpretation. Accordingly, comparative trend data for the Commonwealth itself may not provide the users of the financial statements with sufficient data to make appropriate decisions.

The Commonwealth should consider providing information about other states on its website that would allow users a tool for peer analysis. The decision as to which other states ought to be included should take into consideration population and demographic data, programmatic similarities and other factors that would lead to effective comparison. The rationale for the states included could also be provided. Such information can be obtained from the CAFRs published for those states or through industry associations such as the GFOA or the National Association of State Comptrollers.

Compliance with Chapter 647, the Internal Control Act
Massachusetts General Law, Chapter 647, *State Agencies Internal Control Act of 1989* ("Chapter 647"), outlines internal control standards, defines the minimum level of internal control systems and establishes the criteria against which internal controls will be evaluated. Chapter 647 also states "Internal control systems for the various state departments shall be developed in accordance with guidelines established by the Office of the Comptroller." The Office of the Comptroller has issued written guidance in the form of the *Internal Control Guide for Managers* and the *Internal Control Guide for Departments*. Departments implement Chapter 647 and these Guides through a document known as the "departments' internal control plan."

Since the passage of Chapter 647, the Office of the Comptroller ("OSC"), in addition to publishing the above-mentioned guides, has assisted departments, when requested, in developing internal control plans; conducted training sessions on internal controls and risk assessments; reviewed departmental internal control plans upon request or as part of the statewide Single Audit. The Single Audits starting in 1999 have been used as a vehicle to promote the OSC's internal control campaign and emphasize compliance with Chapter 647 and OSC Guides.

The OSC campaign to promote compliance with Chapter 647 and its Guides was not promoted as emphatically during the past year primarily because of the implementation of a new accounting and reporting system, NewMMARS. Because of the improvements to the effectiveness, efficiency and economy of operations afforded by full the implementation of NewMMARS, the internal control structure and processes in departments will need to be reassessed. The OSC is aware that internal control changes will be required in departments and plans to reenergize its internal control campaign. We strongly encourage the OSC to lead an initiative to ensure that all departments are updating their internal control documentation for the changes they implement and that such steps are taken as the changes are being made to ensure the maximum level of efficiency in the process. The OSC initiative should include the following:

1. Require departments to reevaluate their risk assessments in light of the changes;
2. Continue to have departments show that they have internal control policies and procedures in place to mitigate the risks detailed in their risk assessments;
3. Continue to work with those departments that have developed internal control plans that most closely comply with the Guides to be used as a model for other departments to follow; and
4. Consider developing a template or model internal control plan or risk assessment component for those departments with common operations, such as the 15 community colleges and the 10 sheriffs' offices.

Accounting for Disposal of Fixed Assets

The Commonwealth's fixed asset system relies on the individual departments to record the disposal of fixed assets. The process could use improvement. The Massachusetts management Accounting and Reporting System ("MMARS") provides a detailed list of equipment in the Commonwealth by department which supports the balances reflected in the Commonwealth's financial statements. During test work to verify the existence of assets in the opening balance it was determined that the Information Technology Division ("ITD") had not recorded the disposal of computer equipment in the Commonwealth's Fixed Asset System. In discussion with senior management at ITD it was discovered that the department had failed to record the disposal of multiple assets. ITD did have a recent physical inventory report which properly included only the assets in use. However, a reconciliation between the inventory and what was recorded in the Commonwealth's Fixed Asset System had not been performed.

The Office of the Comptroller ("OSC") should issue a reminder to departments that they are required to reconcile physical inventories to what is recorded in MMARS at least annually. The reminder should also request departments to perform a high level review of the relationship of the department's net book value to the cost of its assets as part of the work done each year to prepare the Commonwealth's depreciation schedules.

OFFICE OF THE COMPTROLLER

GAAP Packages

The Office of the Comptroller ("OSC") requires each department to submit a "GAAP Package" to its Financial Accounting and Reporting Bureau ("FRAB"). The purpose of the GAAP Package is to properly accumulate the information needed to report the Commonwealth's financial condition under generally accepted accounting principles ("GAAP") in accordance with the standards promulgated by Government Accounting Standards Board ("GASB"). OSC distributes instructions to all departments detailing the information needed, including accruals for receivables, leases and other balances.

The OSC set August 9, 2004 as the submission deadline for the GAAP Packages. Forty-three priority III departments failed to submit a GAAP Package for FY 2004. Many of these departments also failed to file GAAP packages in prior years as well. This forces FRAB to make certain estimates and assumptions in order to prepare statements. Although these priority III departments are immaterial individually and in the aggregate, the amounts should be reported to provide an accurate financial picture.

OSC should continue to communicate with departmental Chief Fiscal Officers in upcoming meetings the importance of that information and the need to prepare this package in a timely manner.

Accounting for Fixed Assets

In prior years the Commonwealth's fixed assets system was outdated and was not capable of reporting all of the fixed assets information required to be reported in the Commonwealth's financial statements without a significant amount of manual intervention. Specifically, the system was incapable of calculating the annual depreciation charge for the Commonwealth's fixed assets.

NewMMARS has been programmed to have the capability of tracking and accounting for fixed assets, including the calculation of depreciation expense. However, this functionality was not available in the timeframe needed for the FY 2004 audit. As a result, the Office of the Comptroller ("OSC") was required to calculate depreciation expense using a series of spreadsheets which are used to track cumulative depreciation charges and net book value. While this process is functional, it is not subject to systemic controls.

Reports have been run as of June 30, 2004 calculating the accumulated depreciation up to and including June 30, 2004 in NewMMARS on a test basis. Reconciliation of that information to what was calculated manually is underway.

OSC should continue to try to calculate depreciation expense using the functionality of the NewMMARS system.

Short-Term Investment Reconciliations

The Office of the Comptroller ("OSC"), in conjunction with the Office of the State Treasurer ("Treasury"), performs a quarterly reconciliation of short-term investments. The reconciliation is between OSC's MMARS system, Treasury's investment system, CMS, and the bank's records. The primary reconciling items include redemptions and purchases that occur close to quarter end that are not recorded on the books but are reflected in the bank statements. For example, for the quarter ended June 30, 2004, there were $1.676B in redemptions, and $33M in purchases that occurred that were reflected in the bank statement but not in the CMS system.

The CMS system is always one day behind in recording transactions. Once the transactions are booked to CMS, there is an inter-face between CMS and MMARS to record the transactions in MMARS. As a result, MMARS is generally two days behind in booking short-term investment transactions. Because of these timing differences, there will generally be reconciling items between bank, CMS and MMARS.

In FY 2004, the MMARS balance was not being properly reconciled to the CMS balance. Instead, the MMARS balance was reconciled directly to the bank statements and adjustments were made to the MMARS balance to make it agree to the bank balance. These adjustments were not reviewed for propriety; they were simply recorded to make the balances agree. As of June 30, 2004, the bank investment balance was accurate and therefore, it was appropriate for the OSC to adjust the MMARS balance to equal that of the bank. However, the Treasury is responsible for investment transactions and therefore the department most knowledgeable about how the transactions should be recorded. When OSC makes the MMARS balance equal the bank balance, the reconciliation between the Treasury system and the OSC system becomes ineffective.

A reconciliation should first be performed between the CMS balance and the bank balance and then a reconciliation to MMARS should be performed. If the MMARS balance is to be adjusted based on the reconciliation process, the Treasury should be informed so that they can ensure that it is appropriate for the entries to be made based on their knowledge of the investment transactions.

Cross Training

Cross training is needed within the Office of the Comptroller ("OSC") for certain key functions relating to financial statement reporting and general accounting. Within OSC's financial reporting and general accounting units there are many specialized and important tasks which only one employee is formerly trained to perform.

OSC can improve its internal controls by ensuring that more than one employee can perform the functions that it deems important. The cross training of employees can provide many benefits, which include:

- Reduce exposure to the loss of individual's whose institutional knowledge is critical to the control environment and effective functionality of the office.
- An increase in efficiency when personnel take time off.
- A reduction in the duplication of effort.
- An expansion of employees' awareness of the entire accounting process.
- A facilitation in the training of new employees.

NewMMARS Training

On July 1, 2004, the Commonwealth implemented a new state-wide accounting system, ("NewMMARS"). Throughout FY 2004 the Office of the Comptroller was responsible for training all users on NewMMARS so that the system could be implemented on July 1, 2004 ("FY 2005"). A multi-disciplined training approach was used including web based e-learning, with some live classroom sessions, web casts open drop in sessions where users could bring their work to complete it with the assistance of a trainer, and department advocates that deployed to department sites to assist departments. A call-in hot-line, manned by OSC employees, was also available to answer user questions.

As with any large accounting system implementation, the users of NewMMARS have encountered problems that their training had not prepared them for. In addition, users at departments have more posting and recording responsibilities than had previously been the case. Discussions with departmental users indicated that while the training prior to the roll-out of NewMMARS adequately prepared them to perform routine daily activities it was not as adequate to deal with unexpected problems and their new responsibilities and that more training would be beneficial.

The OSC has continued the training of departmental users, and developed new classroom training in response to department concerns and the number of problems encountered that users cannot handle has decreased. However, we encourage OSC to continue to offer aggressive classroom training programs to ensure that the users are adequately and appropriately using the NewMMARS system.

Limitation on Users to Input Transactions

The MMARS system allowed certain individuals to input transactions without supervisory review. As a result, there was not adequate segregation of duties, one of key features of good internal controls, with an increase in risk that erroneous entries can be made without being detected.

The implementation of NewMMARS provides a perfect opportunity for the Commonwealth to review user's access to the system and improve internal controls. The instances in which one person is allowed to both enter and approve a transaction within the NewMMARS system should be extremely limited.

OFFICE OF THE STATE TREASURER AND RECEIVER GENERAL

Long-Term Debt Management—Operational Review

The Treasury is responsible for managing the Commonwealth's long-term debt activity. Managing the Commonwealth's $17.4B debt portfolio is a very complex process that involves, among other things, working with departments and agencies from across the Commonwealth to estimate cash needs for capital spending, managing and paying obligations currently outstanding, ensuring compliance with federal arbitrage regulations, reading market conditions to identify potential refunding opportunities, working with underwriters and bond counsel and taking Commonwealth bonds to market. In recent years, this process has been further complicated by the complexity of transactions that the Commonwealth has entered into, including innovative refunding transactions and variable rate bonds that involve imbedded derivatives. With this being said, the Commonwealth should be aware that the Securities and Exchange Commission has shown a growing interest in the area of municipal securities as evidenced through recent public speeches. Thus, the Commonwealth should continue to focus its debt management operations on controls, organizational structure and responsibilities, procurement, risk management, cost/benefit/risk assessment of the structure of deals and overall cost savings.

Stale Reconciling Items

During the review of several of the cash account reconciliations prepared by the Treasury, it was noted that there are several reconciling items greater than twelve months old (amounting to approximately $136,000). All of these items date back to a system conversion that took place in 1992.

The Treasury should review these transactions to determine what they represent and determine the proper adjusting entry necessary to remove the stale items from the account reconciliations.

Enforcement of the Collateral Agreement with Bank of America

The Treasury maintains a collateral agreement with Bank of America requiring minimum collateral of $50B as a condition of the Commonwealth agreeing to do business. At June 30, 2004 Bank of America was not in compliance with that agreement.

The Treasury needs to develop policies and procedures to properly monitor compliance with their collateral agreements, such that they can monitor compliance with collateral agreements that are designed to protect the assets of the Commonwealth.

Staffing Concerns

During our FY 2004 audit of the Treasury, we noticed instances where work was not being completed in a timely manner due to staffing constraints.

As part of our testing procedures, it was noted that draw downs of cash from the federal government to cover payroll and administrative expenses were delayed. These draw downs are supposed to be requested on Tuesday for scheduled vendor payments on Thursday, however, the draw downs were not being processed on the appropriate day. Discussions with Treasury personnel indicated that the primary reason for the delays was the change in banks from Fleet to Sovereign. It was also noted that the Treasury is not consistently tracking the dates on which draw downs are requested and subsequently received. Treasury personnel indicated that a lack of staff contributed to this issue. Treasury management did not agree that staffing was inadequate to perform the drawdown function, but acknowledged that disruptions caused by the banking transition and the Office of the Comptroller's attention to the NewMMARS conversion may have occasionally led to an uneven work load that caused draws to be late. Management did not anticipate any difficulties with the CMIA workload once the workflow of draw files stabilizes following NewMMARS implementation.

The Treasury and Office of the Comptroller should monitor NewMMARS implementation to ensure that adequate staffing is available to drawdown federal cash in a timely manner and effectively comply with all CMIA requirements.

Adherence to Policies and Procedures Set Forth in the Expenditure Classification Handbook

Internal control policies and procedures depicted in the Expenditure Classification Handbook, which is issued by the Office of the Comptroller ("OSC") are the foundation of expenditure reporting in the Commonwealth.

The Treasury maintains a cash management system for debt obligations. OSC has a debt management subsystem that posts debt accounting transactions by object code. Compliance with certain these policies and procedures in the Expenditure Classification Handbook involving debt will allow Treasury and the OSC to enhance reconciliations required to be performed by the OSC between amounts recorded in the Massachusetts Management Accounting and Reporting System ("MMARS"), the official books and records of the Commonwealth, and the Treasury's debt payment system.

Treasury should implement procedures requiring the use of the chart of accounts issued by the OSC including following the Expenditure Classification Handbook.

DEPARTMENT OF REVENUE

Assessment of the Effect of Changes in Tax Law

The Department of Revenue ("Department") is responsible for processing and recording tax transactions for the Commonwealth of Massachusetts ("Commonwealth"). As part of that responsibility, it is the Department's obligation to identify changes in tax law as they occur and the systemic reporting implications of those changes. During FY 2004, a change in tax law enacted in prior years was identified in relation to taxes on the Massachusetts Convention Center, but the systemic effects of that change were not properly assessed.

As a result, an adjustment of approximately $15M was required to be recorded in the books and records of the Commonwealth. In addition, a significant number of man hours were invested by the Department in an attempt to assess the errors that had been made as a result of the failure to effectively assess the reporting requirements to comply with this change in tax law. While the adjustment was made before the issuance of the financial statements, it was not identified in the normal course of business. Instead, the Department came across this error in the course of performing a review of certain tax fluctuations.

While the Department has made an effort to identify these changes, they need to develop more effective internal control policies and procedures to assess the reporting implications that changes in tax law create. In addition to implementing new controls, management of the Department should consider re-visiting tax law changes in recent years to ensure that the systemic reporting system have been updated to address these changes.

From a risk perspective, identifying the effects of a change in tax law after the fact is not conducive to effective internal controls. Controls should be designed to proactively address potential risks. The Department is the primary revenue reporting unit for the Commonwealth, therefore failure to identify improper reporting practices can result in material adjustments to the financial statements.

INFORMATION TECHNOLOGY DIVISION

Business Contingency and Disaster Recovery Plans have not been Finalized

While tremendous strides have been taken over the past year in the area of Disaster Recovery and Business Contingency Planning ("BCP"), including the hiring of a BCP Consultant and identifying a potential site for the secondary Data Center, there is no overall Business Contingency Plan in place for all systems maintained by the Information Technology Division ("ITD"). At the present time, the plans for the second data center have not been funded. In addition, the hot site agreement for the recovery of the mainframe environment was renewed over the past year, but there is no agreement or comprehensive plan in place for the recovery of the midrange environment, which includes NewMMARS.

A Disaster Recovery Plan is essential to determine the critical point, after a disruption, that vital processes must be restored. During a business interruption, in the absence of a formalized plan, there is a risk that the organization may not be able to adequately recover key operations reliant upon applications systems to continue with the business in a timely manner

We understand that the establishment of the secondary Data Center and finalizing the overall Business Contingency and Disaster Recovery Plans is a top initiative for ITD in the upcoming year. Once funding for the project is received, we encourage the organization to adhere to the established milestones so that all aspects of the project can be completed as soon as possible.

Testing of System Software Changes by Agencies is not Always Comprehensive

There is an informal testing policy in place for system software changes. Approval from the various agencies can be received via multiple methods. An audit trail is not maintained at all times. As a result, there is no assurance that the particular changes were tested appropriately. It was noted in our discussions that this situation causes problems after 'Go Live', when an agency application does not function appropriately as the "approval" was granted without adequate testing.

The current situation can result in system downtime, strained relations between ITD and the agencies, as well as increased requirements of ITD staff time.

We recommend the development and distribution of defined System Software Change Management procedures, which would require all agencies to formally sign off that testing has been performed prior to a change being implemented into production. This would essentially hold the agencies accountable for the changes made in their respective environments. No migration to production should occur without the receipt of this form.

MASSACHUSETTS TEACHERS RETIREMENT BOARD

Need for Increased Controls over Submission of Teacher's Retirement Data as Reported to the Teacher's Retirement Board ("TRB")

In order to accurately track Teacher Retirements, the Teacher's Retirement Board ("TRB") collects data from every school district in the Commonwealth. Chapter 32 of the Massachusetts General Laws requires that the data must be submitted to the TRB within 10 days after the end of the month. This data includes demographic information (name, address, date of birth, etc.), information regarding the individual teachers' retirements (contribution rate, contribution amounts, date of hire, years of service, etc.), teachers' contribution information (percentage of salary withheld, total dollars withheld for the pay period, etc) and the actual amount collected from employee contributions.

In the past, this information was difficult to obtain, because there was no common system for receiving this data. However, in 1997, the TRB developed a uniform reporting format, which is compatible with major commercial payroll-reporting software packages (such as ADP, Munis, etc.). The TRB also developed and provided a reporting software package, currently used by over eighty districts and charter schools. Every year, the TRB holds several regional training seminars for school payroll and business officials. The TRB staff also provides on-site training for newly hired school payroll officials and districts having reporting difficulties. In 2004, the MTRB introduced an additional training program designed specifically for new payroll officials. Despite the efforts of TRB, certain school districts within the Commonwealth do not submit the data on a timely basis and TRB is required to pursue the data that is not provided by the school districts. At the time teachers within these districts are ready to retire, TRB is unable to process the retirement paperwork because the records are incomplete. This results in retired teachers not being able to receive their retirement benefits in a timely manner. In addition, when the districts do not submit retirement contributions on time, the teacher's overall benefits will suffer since the TRB is unable to earn investment income on contributions that they have not yet received. Moreover, several schools have not yet adopted compatible payroll software packages causing errors when TRB compiles information. TRB has controls in place to identify a change from previous periods so the errors are detected. However, as a result of the errors further delays are occurring while TRB corrects all errors.

Chapter 32, Section 18, Paragraph 1A, states: "If the Board…determines that there has been an unreasonable delay in filing of any…required information, the Board…shall so notify in writing such treasurer or other disbursing officer. If within thirty days thereafter, the Board…has not received such required information, the Board…may petition the superior court to compel compliance with this section and enforce the penalty there under."

In order to remedy the current situation, the Board should continue to notify the district officials responsible for reporting the districts' information and remitting the appropriate contributions. If all else fails, the TRB should use the option of petitioning the superior court to enforce compliance.

The TRB has established cooperative relationships with the Department of Education and the Public Employee Retirement Administration Commission for the purpose of inducing school districts that are delinquent in their reporting responsibilities to hasten a solution. Additionally, the Board has submitted legislation that would require local school districts to submit monthly data and contributions on a timelier basis or be subject to an interest penalty.